

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:LM:NR:DEN:POSTF-164614-01

WRDavis

date: 19 APR 2002

to: Team Coordinator, [REDACTED] audit (LMSB:CTM)  
Attn: [REDACTED]

from: Area Counsel  
(Natural Resources:Houston)

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subject: [REDACTED] - Termination Fee:  
Does I.R.C. § 6103 Prohibit Access to Information Obtained about  
the Termination Fee by the [REDACTED] Audit Team?  
EIN: [REDACTED]  
Address: c/o [REDACTED]  
[REDACTED], ATTN: [REDACTED]

We respond to the portion of your request concerning whether I.R.C. § 6103 would prohibit disclosure of information relevant to the proper treatment of the termination fee paid by [REDACTED] (" [REDACTED]" or "taxpayer") to [REDACTED] as a result of the taxpayer's termination of its agreement to be acquired by [REDACTED]. The scope of these questions is set forth below. This memorandum should not be cited as precedent.

Please note that, as nondocketed significant advice, this advice is subject to a 10-day post-review by Chief Counsel National Office. Once this review has been completed, I will contact you to advise of its acceptance upon review, or of any modifications to the proposed response.

**DISCLOSURE STATEMENT**

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

**ISSUES**

1. May the audit team examining the taxpayer's [REDACTED] taxable year obtain information relating to the tax treatment by [REDACTED] (" [REDACTED]" ) of its receipt of the termination fee or to other transactions between [REDACTED] and [REDACTED]

██████ ("██████") that were related to the termination of the ██████ - ██████ merger agreement from that examination team that was provided to the Service in connection with ██████'s return or the examination of its returns without violating I.R.C. § 6103(a)?

2. If the audit team examining the taxpayer's ██████ taxable year may obtain the information described in issue 1., above, may it then disclose that information to the taxpayer by including it in the Revenue Agent's Report ("RAR") issued to the taxpayer?

3. If the audit team examining the taxpayer's ██████ taxable year obtains information relating to the ██████ - ██████ merger agreement including, but not limited, to the termination of that agreement by summoning third parties pursuant to the taxpayer's examination, would it violate I.R.C. § 6103(a) for the team to disclose the information by including it in the RAR issued to the taxpayer?

#### CONCLUSIONS

1. I.R.C. § 6103(h)(1) authorizes the taxpayer's audit team to obtain from sources within the Service, such as other examination teams or issue specialists, information relating to ██████'s treatment of the termination fee it received that was paid by the taxpayer and its treatment of other transactions between ██████ and ██████ that were related to the termination of the ██████ - ██████ merger agreement. The taxpayer's audit team has a need to know the information to perform a tax administration function.

2. I.R.C. §§ 6103(h)(4)(B) and/or (C) authorize the taxpayer's audit team to disclose the information obtained in issue 1., above to the taxpayer by including the information in the RAR, as that third-party tax information directly relates to a transactional relationship between the taxpayer and those third parties which directly affects the resolution of an issue in a proceeding.

3. I.R.C. §§ 6103(e)(1)(D) and (e)(7) authorize the taxpayer's audit team to disclose to the taxpayer in its RAR information summoned from third parties that is related to either the termination of the ██████ - ██████ merger agreement because such information was collected by the Service with regard to the taxpayer's liability or possible liability under the Code; so long as such disclosure will not seriously impair Federal tax administration.

**FACTS**

The taxpayer, [REDACTED], filed a consolidated Federal income tax return for the taxable year [REDACTED] as the common parent of a consolidated group. On this return, the taxpayer deducted \$[REDACTED] that it paid [REDACTED] as either a business expense under I.R.C. § 162 or an abandonment loss under section 165. The facts leading up to that transaction are explained more fully below.

On [REDACTED], the taxpayer and [REDACTED] entered into an agreement which called for the taxpayer to merge with and into [REDACTED] or a wholly-owned subsidiary thereof ("merger agreement"). The agreement set a date by which the transaction was to take place. Additionally, under certain conditions, it required the payment of a fee of \$[REDACTED] by a party terminating that agreement to the non-terminating party. The agreement prohibited the taxpayer from soliciting other offers. Yet, it set the time frame within which the taxpayer could consider unsolicited alternate transactions to the [REDACTED] merger, terminating that period forty-five (45) days after the agreement date. It further defined what was considered as a "superior offer," and included notice requirements in the event that the taxpayer opted to terminate the agreement for a superior offer.

On [REDACTED], the taxpayer received an unsolicited offer from [REDACTED] to acquire each of the taxpayer's shares of common stock. On [REDACTED], [REDACTED] made a binding offer to the taxpayer, by which it agreed to enter into the merger agreement it proposed on [REDACTED] with the taxpayer, and to loan the taxpayer the funds to pay the \$[REDACTED] termination fee to [REDACTED] in consideration for the taxpayer's termination of the [REDACTED] merger agreement. Thereafter, the taxpayer delivered a notice to [REDACTED], indicating the taxpayer's intention to terminate the [REDACTED] merger agreement. Under that agreement, the taxpayer's notice started the [REDACTED]-day period within which [REDACTED] could make a counter-offer to the taxpayer.

On [REDACTED], [REDACTED] notified the taxpayer that it did not intend to make a counter-offer, and that it would accept termination of the [REDACTED] merger agreement upon receipt of the \$[REDACTED] termination fee. These two things were accomplished on [REDACTED], with [REDACTED] funding the termination fee through a loan. Also, on that date, the taxpayer executed the [REDACTED] merger agreement. Thereafter, on [REDACTED], the taxpayer merged into [REDACTED], a first-tier subsidiary of [REDACTED], and the consolidated group having [REDACTED] as its common parent ceased to exist.

Additionally, at the time of its tender offer to [REDACTED], [REDACTED] reached agreement with Comcast concerning at least two areas: for one, [REDACTED] sold several [REDACTED] to [REDACTED] and granted [REDACTED] rights to purchase several others. As we understand it, the [REDACTED] were sold to prevent regulatory problems that [REDACTED]'s acquisition of [REDACTED] would otherwise have caused. The second area of agreement concerned the provision and marketing of [REDACTED]'s [REDACTED] by [REDACTED] over, [REDACTED].

The taxpayer deducted the termination fee as either a business expense under section 162 or an abandonment loss under section 165. The [REDACTED] audit team has questioned the taxpayer's treatment of that payment, and is considering whether the payment should be treated as a capital expense under section 263.

The [REDACTED] audit team has information that relates to that taxpayer's treatment of the receipt of the termination fee from [REDACTED]. In a claim for refund, it appears that [REDACTED] has recharacterized this receipt as a nontaxable receipt of liquidated damages for damage to its business reputation.

#### ANALYSIS

1. I.R.C. § 6103(a) prohibits Service employees from disclosing "returns" or "return information," as those terms are defined in sections 6103(b)(1) and (b)(2), unless disclosure is authorized under a specific provision of Title 26. Section 6103(b)(2) defines return information to include, among other things, any data which is received by, recorded by, prepared by, furnished to, or collected by the Service with respect to a return or with respect to the determination of the existence or possible existence of liability or the amount of liability of any person under Title 26.

Section 6103(h)(1) authorizes the disclosure of returns or return information to officers and employees of the Treasury Department whose official duties require such disclosure for tax administration purposes. Tax administration is defined as "the administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws or related statutes." Section 6103(b)(4). In essence, section 6103(h)(1) authorizes access to tax information to an employee of the Service when that employee establishes a "need to know" in order to perform a tax administration function. An examination of a taxpayer's return is a tax administration function.

Here, information relating to [REDACTED]'s treatment of the termination fee it received from the taxpayer that was provided to the Service by [REDACTED] in connection with its own return or the examination of its own return is return information of [REDACTED]. Under section 6103(h)(1), the taxpayer's examination team is authorized to obtain return information collected by the Service during the examination of the other party to this transaction, provided that the examination team has a need to know such information in order to perform a tax administration function. Review of such information by the taxpayer's examination team would occur during the course of the team's official duties of tax administration, i.e., the examination of the taxpayer. Given that such information is ~~helpful in~~ *directly related* determining the proper treatment of the \$ [REDACTED] payment by the taxpayer to [REDACTED], the [REDACTED] examination team has a need to know the information and the disclosure of such information to that examination team is authorized under section 6103(h)(1).

2. [REDACTED] provided information about the termination fee to the Service. As was discussed in issue 1 above, because the Service obtained that information in connection with the examination of [REDACTED]'s return, it constitutes "return information" of [REDACTED]. Although section 6103(h)(1) permits the taxpayer's examination team to obtain that information, this section does not authorize the examination team to disclose the information of [REDACTED] to the taxpayer in its RAR. Third-party tax information may only be disclosed by the Service to the taxpayer under sections 6103(h)(4)(B) and/or (C).

Section 6103(h)(4) is a narrowly-tailored exception to the confidentiality requirements of section 6103(a), which authorizes disclosure of certain tax returns and return information in judicial or administrative tax proceedings. Subparagraphs (B) and (C) of section 6103(h)(4) establish item and transaction tests, respectively, under which returns and return information of taxpayers who are not parties to such proceedings may nevertheless be disclosed. Under section 6103(h)(4)(B), a third-party taxpayer's returns or return information may be disclosed in judicial or administrative tax proceedings only "if the treatment of an item reflected on such [third party's] return is directly related to the resolution of an issue in the proceeding." Under section 6103(h)(4)(C), a third-party taxpayer's returns or return protected information may be disclosed in judicial or administrative tax proceedings only "if such [third party's] return or return information directly relates to a transactional relationship between a person who is a party to the proceeding and the [third party] taxpayer which directly affects the resolution of an issue in the proceeding."

In the circumstances presented here, the relevant inquiry is whether subsection (B) and/or (C) permit the [REDACTED] examination team to disclose to that taxpayer, in its examination, information relating to the termination fee paid by the taxpayer to [REDACTED] that was provided to the Service by [REDACTED] in connection with its own return or the examination of its return. We believe that they do.

An examination is an administrative proceeding pertaining to tax administration. First Western Government Secur. Inc. v. United States, 796 F.2d 356, 360 (10th Cir. 1986), aff'g 578 F. Supp. 212 (D. Colo. 1984); Abelein v. United States, 2001-2 U.S.T.C. ¶ 50,592 (W.D. Wash. 2001); Nevins v. United States, 88-1 U.S.T.C. ¶ 9199 (D. Kan. 1987) (an audit is an administrative proceeding for purposes of section 6103(h)(4)); but see Mallas v. United States, 993 F.2d 1111, 1121-22 (4th Cir. 1993) (an audit is not an administrative proceeding for purposes of section 6103(h)(4)). The Service must often disclose third-party tax information to substantiate its position in the examination. This facilitates early resolution of issues at the administrative level. It would be incongruous to require the Service to wait until the case is litigated to disclose any third party information supporting an adjustment.

An RAR is one of the final steps and is a part of the examination of the Federal income tax return of the taxpayer, satisfying the requirement that the disclosure is in a judicial or administrative tax proceeding. Next, we examine whether the item and/or transaction tests of section 6103(h)(4)(B) and/or (C) are met in order to allow the Service to disclose third-party information in an RAR to be issued to the taxpayer during its examination. Two statutory requirements under section 6103(h)(4)(C) must be met to disclose third-party tax information in an administrative proceeding: first, that the information must relate to a transactional relationship between the taxpayer and the third party; second, that the information directly affects the resolution of an issue in the proceeding.

Here, the return information of [REDACTED] relating to the termination fee transaction meets the first part of the test, since [REDACTED] was the other party to the merger that was, in part, terminated through payment of the termination fee. The fee that [REDACTED] received is the same fee paid by the taxpayer.

The second requirement of the transactional relationship test is also met as the information directly affects the resolution of an issue in the proceeding: did the termination fee serve to create or enhance a long-lived asset of [REDACTED]? If this payment provided [REDACTED] with the ability to merge with

[REDACTED], and this business combination constituted a long-lived asset, it likely requires capitalization. At the same time that [REDACTED] was terminating the [REDACTED] merger agreement and entering into the [REDACTED] merger agreement, [REDACTED] and [REDACTED] were entering into a related agreement that likely affected the long-term value of the combination of [REDACTED] and [REDACTED]. In fact, one portion of that agreement--[REDACTED]'s sale of several [REDACTED]--may well have been required for the merger to gain regulatory approval. [REDACTED]

[REDACTED] . We believe that these facts directly affect the way in which [REDACTED]'s payment of the termination fee should be viewed. Thus, under sections 6103(h)(4)(B) and/or (C), information relating to the termination fee provided to the Service by [REDACTED] in connection with its own return or the examination of that return may be disclosed by the Service to the taxpayer in an RAR to be issued to the taxpayer during its examination.

3. As noted previously, section 6103(a) prohibits Service employees from disclosing "returns" or "return information" as those terms are defined in sections 6103(b)(1) and (b)(2), unless disclosure is authorized under a specific provision of Title 26. Should information be summoned by the taxpayer's exam team via summonses to third-parties pursuant to its examination of [REDACTED], the summoned information would constitute the return information of [REDACTED], as that information would be collected by the Service with regard to [REDACTED]'s potential liability under the Code.<sup>1</sup> First Western Government Secur. Inc., 796 F.2d at 359-60; Mid-South Music Corp. v. United States, 818 F.2d 536 (6th Cir. 1987).

Section 6103(e) stands as an exception to the confidentiality provisions of section 6103(a) and permits disclosure of tax information to the taxpayer and certain other persons having a material interest. Specifically, section 6103(e)(1)(D) permits the disclosure, upon written request, of a return of a corporation or a subsidiary to any person delineated in this Code provision. Further, section 6103(e)(7) allows the Service to disclose return information to any person authorized

<sup>1</sup> Please ensure that, with regard to any summons of third-party records, you comply with the requirements of section 3417 of the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685, 757, which amended I.R.C. § 7602(c), notice of IRS contact of third parties. Feel free to contact this office to discuss any of those requirements.


by this subsection to receive the return, if such disclosure would not seriously impair Federal tax administration.<sup>2</sup> Therefore, under sections 6103(e)(1)(D) and 6103(e)(7), the taxpayer's examination team may disclose the summoned tax information to the taxpayer, provided that such disclosure would not seriously impair Federal tax administration.

Alternatively, the taxpayer's own return information can be disclosed to it pursuant to section 6103(h)(4)(A). That section authorizes the disclosure of a taxpayer's return information "in a Federal or State judicial proceeding pertaining to tax administration . . . if the taxpayer is a party to the proceeding, or the proceeding arose out of, or in connection with, determining the taxpayer's civil or criminal liability, or the collection of such civil liability, in respect of any tax imposed under this title." As discussed above, an examination is an administrative tax proceeding to which the taxpayer is a party.

Please contact the undersigned at (303) 844-2214, ext. 259, if you have any further questions.

BERNARD B. NELSON  
Area Counsel  
(Natural Resources:Houston)

By:

  
WILLIAM R. DAVIS, JR.  
Attorney (LMSB)

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<sup>2</sup> A written request is not required for return information, in contrast to disclosure of the return.